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Supreme Court of the United States.

OCTOBER TERM, 1934.

No. 413

GULF, MOBILE & NORTHERN RAILROAD COMPANY,
PETITIONER,

v.

GUY T. HELVERING, AS COMMISSIONER OF INTERNAL REVENUE, RESPONDENT.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS DISTRICT OF COLUMBIA

AND

SUPPORTING BRIEF.

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Petitioner,
v.
GUY T. HELVERING, as Commissioner of Internal Revenue,
Respondent.
} No.....

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS, DISTRICT OF COLUMBIA.

This is a petition for a writ of certiorari to the United States Court of Appeals, District of Columbia, involving a decision by that Court in the case of Gulf, Mobile & Northern Railroad Company v. Guy T. Helvering, as Commissioner of Internal Revenue (substituted for David Burnet, Commissioner of Internal Revenue, R. 127), No. 5854, wherein the Court affirmed a decision of the United States Board of Tax Appeals upon the two questions here presented. The Court's opinion was entered on May 14, 1934 (R. 128-134), and the Court's judgment was entered on May 14, 1934 (R. 135). A modified judgment was entered June 25, 1934 (R. 135-136). The opinion of the Board of Tax appeals is reported at 22 B. T. A. 233.

Petitioner will hereinafter be referred to as the "taxpayer."

QUESTIONS PRESENTED.

The case presents the following questions:

1. What is the correct method of computing taxpayer's profit, if any, when it turned over to the President of the United States on December 31, 1917, under the provisions of the Federal Control Act, its inventory of material and supplies costing $286,664.26, and on February 29, 1920, received back through the Director General of Railroads an inventory of material and supplies which had cost the Director General $275,912.03, and later in the final settlement with the Director General received $61,314.18 as settlement in full of the account?

2. When taxpayer and its subsidiary, the Meridian & Memphis Railway Company, are affiliated for income tax purposes under the law in 1924, 1925, and 1926, and taxpayer owns the outstanding bonds of the subsidiary, and the latter writes off in each of those years an aliquot part of the discount at which it originally sold its bonds to the public before taxpayer had acquired any of its stock or bonds, and deducts such amounts from income in the respective years, are such transactions inter-company transactions so as to prevent the deductions in the consolidated returns?

SUMMARY STATEMENT OF THE MATTER INVOLVED.

1. Taxpayer is a corporation organized January 1, 1917, with principal office at Mobile, Alabama. Ever since organization it has been engaged in operating the Gulf, Mobile & Northern Railroad system (R. 21, Item 5 (a) of amended petition, admitted in answer, R. 26; R. 56).

Taxpayer's railroad and equipment were taken over by the President of the United States under the Federal Control Act on December 31, 1917, and were under the control of the Director General of Railroads throughout the period January 1, 1918, to February 29, 1920, inclusive. Included therein was an inventory of material and supplies which

had cost taxpayer $286,664.26. The properties were turned back to taxpayer at midnight on February 29, 1920, under the terms of the Transportation Act of 1920. The material and supplies turned back had cost the Director General $275,912.03 (R. 58).

There was no written "standard agreement" between taxpayer and the Government in respect to Federal Control of its properties. After the properties were returned to taxpayer on February 29, 1920, it made a final settlement with the Director General in which it was allowed $61,314.18 as settlement in full of the material and supply account (R. 58).

In the aforesaid final settlement, taxpayer was allowed the sum of $61,314.18 on its claim for *shortages* in the inventory of material and supplies turned back to it by the Director General over the inventory of material and supplies which it turned over at the beginning of the period (R. 112-114).

When the President took over taxpayer's properties as of December 31, 1917, an entry was made on its books charging the United States with $286,664.26, the cost of material and supplies. This entry stood until after the final settlement with the Director General, when it was cleared in 1920, with all the other accounts entering into said settlement, through the profit and loss account. This charge to the United States was not an account receivable, but was a memorandum charge, because taxpayer expected to have the material and supplies returned in kind, grade, and quality as the law provided (R. 114-115, 118-119).

In computing the taxpayer's net income for 1920 the Commissioner included therein the sum of $50,561.95, arrived at by taking from the sum of the inventory of material and supplies turned back plus the amount allowed taxpayer in the final settlement, the amount of the original inventory. The Board of Tax Appeals approved this action of the Commissioner (R. 58, 82-84) and the Court affirmed the Board (R. 135).

2. During 1913 to 1916, inclusive, taxpayer's subsidiary, the Meridian & Memphis Railway Company, sold its bonds at a discount and, under the Interstate Commerce Commission rules, set up on its books the amount of its discount as a deferred charge to be amortized over the remaining life of the bonds. It has consistently written off each year the applicable part of said discount and, in each of the years 1924, 1925, and 1926, it wrote off $4,585.32 and deducted that amount from its income for the respective years (R. 61, 119, 126).

On or about January 1, 1917, taxpayer acquired all of the stock of the Meridian & Memphis Railway Company so that the two companies were affiliated for income tax purposes from that time until after 1926, the last year involved in this proceeding (R. 56).

Soon after February 29, 1920, taxpayer acquired all of the outstanding bonds of the Meridian & Memphis Railway Company and held them until after 1926, the last year involved in this proceeding (R. 61).

In the consolidated returns, filed by taxpayer for itself and the Meridian & Memphis Railway Company, a deduction of $4,585.32 was taken each year in respect of the aforesaid bond discount amortization of the Meridian & Memphis Railway Company. The Commissioner of Internal Revenue disallowed the deductions on the ground that the bonds were inter-company obligations and that the writing off of the discount constituted an inter-company transaction (R. 38, 61). The Board of Tax Appeals approved the Commissioner's determination (R. 88), and the Court affirmed the Board (R. 135).

REASONS RELIED UPON FOR ALLOWANCE OF THE WRIT.

1. This Court should grant certiorari on the material and supply question for the following reasons:

(a) The decision of the Court of Appeals is in conflict with the principle enunciated in the decision of the Circuit

Court of Appeals, Second Circuit, in *Lehigh & Hudson River Railway Company* v. *Commissioner,* 36 Fed. (2d) 721. (See brief, *infra.*)

(b) The question is an important question in revenue taxation affecting a great many railroads whose tax cases have not yet been settled.

(c) In approving the Commissioner's determination, the Court of Appeals overlooked the fact that there was no sale of the inventory of materials and supplies by taxpayer and that the cash payment was *only* for the quantity of material and supplies which the Director General was not able to return in kind; in other words, the Court of Appeals overlooked the provisions of the Federal Control Act whereby the President, or his agencies, were required to return the property in kind at the end of the control period, in consequence of which the cash settlement must necessarily be payment only for the material not returned. (See brief, *infra.*)

(d) The Commissioner's method of computing the profits, and therefore the Court's approval thereof, is wrong on the face of it, when the facts and law are taken into consideration. (See brief, *infra.*)

2. This Court should grant certiorari on the bond discount question for the following reasons:

(a) It is a very important question in Federal taxation affecting numerous other taxpayers and arising frequently under the various revenue acts.

(b) The Commissioner's determination, approved by the Court, does not conform to the generally accepted definition of an inter-company transaction. (See brief, *infra.*)

(c) No reason has ever been given by the Board or any Court to support the Court's position taken in this case. The first time the question arose before the Board of Tax Appeals, which was in *New Orleans, Texas and Mexico Railroad Co.,* 6 B. T. A. 436, the Board, without discussing the question, decided it on the authority of another case which did not decide the question at all. Since then, every

time the question has arisen, either before the Board or in the Courts, it has been decided, without comment, on the authority of the Board's decision in the *New Orleans, Texas and Mexico Railroad Co.* case, *supra,* where, as stated, the supporting authority was not in point at all. (See brief, *infra.*)

(d) The writing off of bond discount by the Meridian & Memphis Ry. Co. was the writing off of a deferred charge which does not affect the income of taxpayer in any way any more than the writing off of depreciation would affect taxpayer. It is therefore not an inter-company transaction and this Court should grant certiorari and decide the question, once and for all, in order to prevent the great number of erroneous decisions which will follow on bond discount and analogous questions in consolidated cases unless this Court speaks.

(e) The decision of the Court of Appeals is in direct conflict with the principles enunciated in

Alpha Portland Cement Co. v. *U. S.* (Ct. Cls.), 44 Fed. (2d) 92;

Hernandez v. *Charles Ilfeld Co.* (10 C. C. A.), 66 Fed. (2d) 236.

(See brief, *infra.*)

(f) Finally, the decision of the Court of Appeals is directly in conflict with the principle enunciated in the decision of this Court in

Burnet v. *Aluminum Goods Mfg. Co.,* 287 U. S. 544, 53 S. Ct. 227,

wherein this Court held that a real loss of one member of an affiliated group, which was also a real loss of the single business of the group, was deductible in computing the consolidated income of the group.

WHEREFORE, your petitioner prays that a writ of certiorari be issued out of and under the seal of this Honorable Court directed to the United States Court of Appeals, District of Columbia, commanding that Court to certify and transmit to this Court for review and determination on a date to be therein named, a full and complete transcript of the record and of the proceedings in the case numbered and entitled on its docket No. 5854, *Gulf, Mobile & Northern Railroad Company,* appellant, v. *Guy T. Helvering,* as Commissioner of Internal Revenue (substituted), appellee; and that said judgment of said Court be reversed by this Honorable Court on the questions here raised and that your petitioner have such other and further relief in the premises as to this Honorable Court may seem meet and just, and your petitioner will ever pray.

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BRIEF IN SUPPORT OF PETITION FOR WRIT OF CERTIORARI.

The opinion of the United States Court of Appeals, District of Columbia, was entered May 14, 1934, and appears in the printed record at pages 128 to 134, inclusive. The Court's judgment was entered May 14, 1934, and appears at page 135 of the record.

The Court's modified judgment was entered June 25, 1934, and appears at pages 135-136 of the record.

JURISDICTION.

The jurisdiction of this Court is invoked under Section 240 of the Judicial Code, as amended by the Act of February 13, 1925, and under Section 1003 of the Revenue Act of 1926.

FACTS.

The facts are set out in the petition above in the "Summary Statement of the Matter Involved" and for the sake of brevity are not repeated here.

STATUTES AND REGULATIONS.

This case involves the following provisions of law and regulations:

Federal Control Act enacted March 21, 1918:

> Sec. 1. That the President, having in time of war taken over the possession, use, control, and operation (called herein Federal control) of certain railroads and systems of transportation (called herein carriers), is hereby authorized to agree with and to guarantee to any such carrier making operating returns to the Interstate Commerce Commission, that during the period of such Federal control it shall receive as just compensation an annual sum, payable from time to time in rea-

sonable installments, for each year and pro rata for any fractional year of such Federal control, not exceeding a sum equivalent as nearly as may be to its average annual railway operating income for the three years ended June thirtieth, nineteen hundred and seventeen.

That any railway operating income accruing during the period of Federal control in excess of such just compensation shall remain the property of the United States. * * *

Every such agreement shall also contain adequate and appropriate provisions for the maintenance, repair, renewals, and depreciation of the property, for the creation of any reserves or reserve funds found necessary in connection therewith, and for such accounting and adjustments of charges and payments both during and at the end of Federal control as may be requisite in order that the property of each carrier may be returned to it in substantially as good repair and in substantially as complete equipment as it was in at the beginning of Federal control. * * *

Sec. 2. That if no such agreement is made, or pending the execution of an agreement, the President may nevertheless pay to any carrier while under Federal control an annual amount, payable in reasonable installments, not exceeding ninety per centum of the estimated annual amount of just compensation, remitting such carrier, in case where no agreement is made, to its legal rights for any balance claimed to the remedies provided in section three hereof. * * *

Sec. 4. That the just compensation that may be determined as hereinbefore provided by agreement or that may be adjudicated by the Court of Claims, shall be increased by an amount reckoned at a reasonable rate per centum to be fixed by the President upon the cost of any additions and betterments, less retirements, and upon the cost of road extensions to the property of such carrier made by such carrier with the approval of or by order of the President while such property is under Federal control.

Revenue Act of 1924:

Sec. 240. (a) Corporations which are affiliated within

the meaning of this section may, for any taxable year, make separate returns or, under regulations prescribed by the Commissioner with the approval of the Secretary, make a consolidated return of the net income for the purpose of this title, in which case the taxes thereunder shall be computed and determined upon the basis of such return. * * *

(b) In any case in which a tax is assessed upon the basis of a consolidated return, the total tax shall be computed in the first instance as a unit. * * *

Section 240 of the Revenue Act of 1926 contains identical provisions applying to the years 1925 and 1926.

Treasury Regulations 65 (applicable to 1924):

Art. 545. * * * * * * * *

(3) (a) If bonds are issued by a corporation at a discount, the net amount of such discount is deductible and should be prorated or amortized over the life of the bonds.

Art. 636. Consolidated net income of affiliated corporations.—Subject to the provisions covering the determination of taxable net income of separate corporations, and subject further to the elimination of intercompany transactions (whether or not resulting in any profit or loss to the separate corporations), the consolidated taxable net income shall be the combined net income of the several corporations consolidated.

Articles 545 and 635 of Regulations 69, applicable to 1925 and 1926, contain the identical provisions.

SPECIFICATIONS OF ERROR.

Taxpayer makes the following assignments of error, which will furnish the basis of the following argument:

1. The Court of Appeals, District of Columbia, erred in sustaining the determination of the Commissioner and the Board that there was a gain of $50,561.95 in the amount returned to taxpayer for material and

supplies at the end of the Federal Control period, in excess of the amount of material and supplies taken over at the beginning of the Federal Control period.

2. The Court of Appeals, District of Columbia, erred in holding with the Commissioner and the Board, that the deductions of $4,585.32 taken by the Meridian & Memphis Railway Company in each of the years 1924, 1925, and 1926 in amortizing its bond discount, were not allowable deductions in computing consolidated net income for those years.

ARGUMENT.

1. The Court of Appeals, District of Columbia, erred in sustaining the determination of the Commissioner and the Board that there was a gain of $50,561.95 in the amount returned to taxpayer for material and supplies at the end of the Federal Control period, in excess of the amount of material and supplies taken over at the beginning of the Federal Control period.

At the close of business December 31, 1917, taxpayer had on hand an inventory of material and supplies which had cost $286,664.26. On January 1, 1918, the President of the United States took over its properties and along with them the said material and supplies. The railroad company then made a memorandum entry on its books charging the United States with $286,664.26 on account of such material and supplies. This entry was never considered an account receivable, but stood as a memorandum charge until the final settlement with the Director General in 1920 (R. 58, 112-119).

Taxpayer neither bought nor sold any material or supplies during the Federal control period. When the property was turned back to taxpayer at midnight of February 29, 1920, under the provisions of the Transportation Act of 1920, the Director General of Railroads delivered over to taxpayer an inventory of material and supplies which had cost him $275,912.03, which was carried at that figure on his

books. This amount was entered on the taxpayer's books on March 1, 1920, as the value of material and supplies received from the Director General and the memorandum charge to the United States of $286,664.26 for material and supplies, made January 1, 1918, remained (R. 58, 112-119).

Negotiations were soon entered into looking to a settlement between taxpayer and the Director General, and on or about September 20, 1920, a final settlement was effected in which the Director General allowed taxpayer the sum of $61,314.18 *in respect of its claim for shortage in material and supplies* returned to it over the quantity which it parted with on January 1, 1918 (R. 58, 112).

The Commissioner computed a profit of $50,561.95 to taxpayer on this transaction, which amount he included in taxpayer's 1920 income—this alleged profit being computed as follows:

Inventory of material and supplies turned over by Director General to taxpayer	$275,912.03
Amount allowed taxpayer in final settlement on inventory and supplies	61,314.18
	$337,226.21
Inventory of material and supplies taken over by the President, January 1, 1918	286,664.26
Difference	$50,561.95

The Board of Tax Appeals and the Court of Appeals approved the Commissioner's determination (R. 58, 82-4, 133).

The material and supplies which the Director General returned to taxpayer were inferior in quality to that which he received (R. 120-122), as well as being less in quantity, but the settlement of September 20, 1920, comprehended an allowance of $61,314.18 *only for actual shortage* (R. 113). Taxpayer received nothing whatever in consideration of the inferior quality of the material and supplies received back from the Director General.

The question presented is: Did taxpayer, in view of the

facts stated, realize taxable income in 1920 in the amount of $50,561.95?

The applicable parts of the Federal Control Act of March 21, 1918, are set out above. The pertinent provisions therein are:

> 1. That the railroads should be paid just compensation for the use of their property (Sec. 1, first paragraph).
> 2. That any excess in railway operating income over the just compensation should remain the property of the United States (Sec. 1, second paragraph).
> 3. That *the property* of each carrier should "be returned to it in substantially as good repair and in substantially as complete equipment as it was in at the beginning of Federal control * * *" (Sec. 1, third paragraph set out above).

Obviously the Government did not intend to pay the owners more than "just compensation" for the use of their property. It did not contemplate returning *the property* and at the same time paying a profit on it, after paying just compensation.

The question of just compensation is not involved here—the Government having discharged its obligation for such. The Director General had no authority to pay more and no authority to pay for property which he returned to the carrier. It must be assumed that he acted within his authority in the instant case, because the Commissioner makes no contention to the contrary.

The question then resolves itself into this: Did taxpayer realize a profit upon an allowance of $61,314.18 made by the Director General in the final settlement, which allowance was necessary in order to make taxpayer whole—to return *the property*?

If the Director General had returned material and supplies in quantity and quality equal to that received by the President on January 1, 1918, of course no allowance would have been necessary. Having failed to do this it was up to

him to make taxpayer whole as provided by the statute set out above.

The Director General failed to make taxpayer whole as to quality, but he did *as to quantity* by the payment of the $61,314.18. The record shows that in the final settlement taxpayer and the Director General matched the quantities of material and supplies taken over against the quantities returned back, and after balancing the overages of one kind against the shortages of another, it would have required $61,314.18 to purchase the excess of the shortages over the overages, and the Director General allowed this amount to taxpayer in the settlement. In other words, it required a payment of $61,314.18 to make taxpayer whole—to put it in the same position as it was January 1, 1918, as to the quantity of material and supplies on hand. This does not take into consideration the fact that the material and supplies returned were of an inferior quality, much of which could not be used by taxpayer at all.

In the face of these uncontradicted facts, the Commissioner claims that taxpayer realized a profit of $50,561.95. Yet to sustain this contention would be to hold that the Director General performed an illegal act—that he paid taxpayer a profit (after paying just compensation) which is not authorized by the law.

The Commissioner obviously confused the increase in market value of materials and supplies from January 1, 1918, to February 29, 1920 (or to September 20, 1920) along with corresponding increases in value of all other property with the realization of taxable profit. If taxpayer had an engine worth $25,000.00 when taken over by the Government on January 1, 1918, and that same engine was worth $35,000.00 when returned, there would be no taxable profit to taxpayer. A profit is realized only upon sale or other disposition of property, yet in the Commissioner's theory, taxpayer would have realized a profit of $10,000.00.

It must be remembered that taxpayer was not buying and selling (as merchandise) the various items entering into its so-called inventory of material and supplies. It was only

buying and carrying on hand a stock for its own use. The fluctuation in the amount in dollars and cents between the beginning and end of the year did not constitute a profit and loss item as in a mercantile business where the "inventory" is the stock in trade. Taxpayer's inventory of material and supplies was as much a capital asset as its engines, cars, and track. All of it was property which the Government took over and all of it was property which the Government was bound under the law to return in substantially as good repair and in substantially as complete equipment as it was in at the beginning of Federal control.

The excess of the value of the inventory on February 29, 1920 (or September 20, 1920), over the value on January 1, 1918, was merely an appreciation in value of the same inventory items or their equivalent, which took place at a time when taxpayer was not in possession of the inventory and consequently not in a position to dispose of it or to realize a profit upon it. *Mere appreciation in value of property does not give rise to taxable income.* Before there can be taxable income, the owner must dispose of the property at a price in excess of his cost. Between January 1, 1918, and February 29, 1920, taxpayer could not dispose of any of its property. The receiving back of it on February 29, 1920, or the equivalent, is the direct converse of disposing of it (*Indiana Harbor Belt Railroad Co.*, 16 B. T. A. 279). How, then, could taxpayer realize a profit? And especially when the Director General was not authorized to pay a profit?

If the Court should hold that the allowance of $61,314.18, paid in order to make good the inventory of January 1, 1918, was equivalent to the sale or disposal of part of said inventory and that it would give rise to taxable income to the extent of the profit therein, then that profit would not be $50,561.95. The only profit which could reasonably be computed on such a holding would be arrived at as follows:

Total cost of inventory of January 1, 1918.....		$286,664.26
Cost of inventory February 29, 1920	$275,912.03	
Allowance necessary to make taxpayer whole	61,314.18	
Total value February 29, 1920.....	$337,226.21	337,226.21
Difference which the Commissioner calls profit..		$50,561.95

$$\frac{50{,}561.95}{337{,}226.21} = .15 \text{ or } 15\%.$$

In other words, every dollar of the $337,226.21 would represent 15 cents profit and 85 cents return of January 1, 1918, cost. Therefore the correct profit, in case the Court should hold that there was any profit, would be, not $50,561.95, but 15% of $61,314.18, or $9,197.13. This amount of $9,197.13 is the most profit that could have been realized by taxpayer on any theory.

Put it another way. The $286,664.26 inventory increased in value between January 1, 1918, and February 29, 1920, to $337,226.21. The quantity which the Director General failed to return, worth $52,117.05 on January 1, 1918, would reasonably have increased in the same ratio. So the Director General paid taxpayer $61,314.18 for this shortage, or a profit thereon of $9,197.13.

In *Lehigh & Hudson River Ry. Co.* v *Commissioner* (2d C. C. A.), 36 Fed. (2d) 721, the same issue was involved as is involved here, but the facts differed. That case was decided on the assumption that the *identical quantity* of material and supplies that was taken over from the carrier on January 1, 1918, was returned to it on March 1, 1920, and that, therefore, the amount of money and property paid to the carrier in excess of its cost was profit computed as follows:

Material and supplies returned 3/1/20	$223,000.00
Cash payment allowed	234,800.00
Total	$457,800.00
Material and supplies taken January 1, 1918	336,000.00
Profit realized	$121,800.00

In approving the decision of the Commissioner and the Board of Tax Appeals, that Court said:

> "(4) A question of fact alone remains. The Commissioner assumed in his calculation that the supplies turned over on March 1, 1920, which had cost $223,000, were equal in quantity to supplies on hand on January 1, 1918, which had cost the same amount. It was by subtracting this sum from the cost of the supplies on hand on January 1, 1918, that he found the cost of the supplies used and not replaced ($113,000), the figure which he subtracted from the allowance ($234,000). Obviously the assumption may or may not have been true; probably it was not, because the cost of such supplies was rising and he must have bought a large part of them during his operation of the road. Suppose for instance that all the supplies were coal whose cost was $4 a ton on January 1, 1918, and an average of $5 between then and March 1, 1920. If the Director General had burnt all the original coal, and the cost of what he turned over on March 1, 1920, was $223,000, that would have amounted to 44,600 tons, and the shortage was 39,400 tons, instead of 28,250. In such case the petitioner's profit was $77,200, instead of $121,800.
>
> The board dealt with this question under the burden of proof, correctly as we think. *It was easy for the railway to prove the shortage in the supplies in kind, without leaving the matter to presumption. It was easy, also, to prove what part of the cost of $336,000 this shortage represented.* Having failed to make such proof, the board could do nothing but assume a dollar for dollar equivalency and fix its profit accordingly." (Italics supplied.)

Thus on the facts in that case, or rather the failure of the

carrier to prove the facts under its burden of proof, the Board and the Circuit Court approved the Commissioner's determination of profit. That this was true is perfectly obvious from the language of the Board in its decision in *Indiana Harbor Belt Railroad Co.*, 16 B. T. A. 279.

In the instant case, however, taxpayer has proven that *the quantity of material and supplies returned was less than the quantity taken over* and that the payment of $61,314.18 was *for this shortage* (R. 113-114). It remains then only to determine how much of this payment represented cost to taxpayer of the shortage and how much was profit. That determination is set out above. The *Lehigh & Hudson River Ry. Co.* case therefore supports taxpayer's contention here made.

In *Los Angeles & Salt Lake Railroad Co.*, 18 B. T. A. 168, the Board of Tax Appeals followed the *Lehigh & Hudson River Ry. Co.* case (*supra*) because in that case also the petitioner had failed to prove "shortage" or "overage" as provided for under its contract with the Director General.

It is, therefore, submitted that taxpayer did not realize a taxable profit of $50,561.95 on material and supplies in the final settlement with the Director General.

2. The Court of Appeals, District of Columbia, erred in holding with the Commissioner and the Board, that the deductions of $4,585.32 taken by the Meridian & Memphis Railway Company in each of the years 1924, 1925, and 1926 in amortizing its bond discount, were not allowable deductions in computing consolidated net income for those years.

During 1913 to 1916, inclusive, the Meridian & Memphis Railway Company sold its 30-year bonds of a face value of $675,000.00 at a discount of approximately $131,000.00. Under Interstate Commerce Commission rules it was not permitted to write off this discount in those years, as the bonds were sold, but was required to set it up on its books

and amortize the amount thereof over the life of the bonds. The amount of such amortization charged off each year after 1916 was $4,585.32 (R. 61, 119-120).

A short time after said bonds were issued taxpayer acquired all the stock of the Meridian & Memphis Railway Company, from which date the two companies have been affiliated for income tax purposes. At the end of the Federal control period taxpayer acquired the outstanding bonds of the Meridian & Memphis Railway Company from the War Finance Corporation, which had acquired them during the Federal control period from the original purchaser thereof. Since that time the Meridian & Memphis Railway Company has paid the interest on said bonds to taxpayer. Likewise the Meridian & Memphis Railway Company continued to write off each year the sum of $4,585.32 as amortization of the discount at which it sold the bonds (R. 61, 119-120).

In computing consolidated net income of taxpayer and the Meridian & Memphis Railway Company for each of the years 1924, 1925, and 1926 the Commissioner disallowed as a deduction the aforesaid amount of $4,585.32 on authority of the decision of the Board of Tax Appeals in *New Orleans, Texas and Mexico Railroad Company,* 6 B. T. A. 436, and the Board likewise followed its former decision, when the instant case came before it, and affirmed the Commissioner's action (R. 38, item j, and 88). The Court affirmed the Board's action (R. 133-4.)

During the years 1924, 1925, and 1926, taxpayer owned the bonds in question and the Meridian & Memphis Railway Company paid to it the interest as it accrued thereon. This interest payment was clearly an inter-company transaction which would not affect consolidated income. On the individual basis, however, the Meridian & Memphis Railway Company would be allowed the deduction from income, because it paid the interest, and taxpayer would be compelled to include the amount in its income because it received it. But when the income of the two companies was

combined into consolidated income, because of affiliation, the one entry off-set the other so that consolidated net income was not affected. The consolidated group had no more and no less than it had before—a splendid illustration of a non-taxable transaction between two affiliated companies. (Art. 636, Reg. 65, and Art. 635, Reg. 69, *supra.*)

But when an item entering into the computation of net income of one member of an affiliated group does not appear conversely in the income of another member it is *not* an inter-company transaction and is *not* eliminated from the consolidated net income.

Such an item was the bond discount item which the Meridian & Memphis Railway Company deducted each year in the amount of $4,585.32. This was not income to taxpayer. Taxpayer did not receive anything. Not only were the net assets of the Meridian & Memphis Railway Company reduced each year by the amount of the deduction, but likewise the *total net assets of both companies together was that much less each year.* Therefore, *it was not an inter-company transaction* and should be allowed as a deduction in consolidated net income just the same as any other deduction of the Meridian & Memphis Railway Company which was not income to the taxpayer. (Art. 636, Reg. 65; and Art. 635, Reg. 69, *supra.*)

It must be remembered that the writing off of the bond discount by the Meridian & Memphis Railway Company was the amortizing of a deferred charge which it incurred through sale of its bonds before taxpayer owned either its stock or bonds. It is the regularly recognized and authorized method of taking care of bond discount when corporations are on the accrual basis, as in this case, and is in conformity with Treasury Department regulations. See Art. 545 of Treasury Regulations No. 65 and 69, *supra.* Taxpayer will realize 100 cents on the dollar at maturity for the bonds of the Meridian & Memphis Railway Company which it holds, so that the writing off of this loss by the Meridian & Memphis Railway Company in no way affects

it. Since the Meridian & Memphis Railway Company could not write off the total discount as the bonds were sold, to deny it the right to amortize the amount over the period is to deny it the loss altogether.

It is not believed that the Commissioner would have disallowed the deductions in question but for the Board's decision in the *New Orleans, Texas & Mexico Railroad Company* case (*supra*). It is therefore pertinent to examine the Board's decision and the facts in that case.

An examination of that case discloses the fact that the Board did disallow a deduction for bond discount incurred under circumstances almost identical with those in the instant case. But the Board did not discuss the issue and rested its decision on the case of *Gould Coupler Co.*, 5 B. T. A. 499. *The latter case decided another issue altogether* and furnishes no authority whatever for the position taken by the Board in *New Orleans, Texas, and Mexico Railroad Company* case.

Consideration of the *Gould Coupler* case, however, is very enlightening in connection with the instant question. There the Board discussed at length the nature of consolidated income in the light of the legislative history of the provision. It sets forth the view that Congress intended consolidated income to be the income of the affiliated group as one economic unit. In the light of this discussion, it appears that taxpayer's contention in the instant case is sound, because, if the Meridian & Memphis Railway Company and it are considered as one economic unit, the unit would still be entitled to the deduction claimed (Sec. 240; Art. 636, Reg. 65; and Art. 635, Reg. 69, *supra*).

The deferred charge for bond discount on the subsidiary's books was an asset just the same as prepaid rent is an asset—just the same as a building is an asset. The loss of any of such assets is an allowable deduction in a consolidated return unless the asset passes to the other affiliate.

This position is supported by the following decisions:

Alpha Portland Cement Co. v. *U. S.* (Ct. Cls.), 44 Fed. (2d) 92;
Hernandez v. *Charles Ilfeld Co.* (10 C. C. A.), 66 Fed. (2d) 236.

In the *Alpha Portland Cement Company* case, the Court of Claims held that where the Alpha Company held all the stock of the Catskill Company and the latter disposed of an asset at a loss—even though it had borrowed the money from the Alpha Company with which to acquire the asset—the loss was deductible in the consolidated return of the two companies for that year.

In the *Hernandez* case, the Circuit Court of Appeals, Tenth Circuit, held that the true income of the affiliated group would be distorted if the separate income and loss of a member of the group is not recognized in the consolidated return.

Finally this Court in *Burnet* v. *Aluminum Goods Mfg. Co.*, 287 U. S. 544, 53 S. Ct. 227, enunciated the same principle when it said, with reference to a loss sustained by one member of an affiliated group of corporations disallowed by the Commissioner on the ground that it was an intercompany loss:

> "The loss was a real one, suffered by respondent as a separate corporate entity, and it was equally a loss suffered by the single business carried on by the two corporations during the period of their affiliation, * * *."

It should be remembered that, in the instant case, we are not dealing with the bonds themselves. The Meridian & Memphis Ry. Co. still owes the face of the bonds which must be paid in full at maturity. There is nothing to prevent taxpayer from selling those bonds at any time, but, regardless of who owns the bonds, the bond discount in question is a deferred charge—an asset—of the subsidiary and the charging off of a part each year is a "*real* loss, suffered by it as a separate entity," and it is also "a loss

suffered by the single business carried on by the two corporations." The net assets of the subsidiary are reduced by the amount charged off each year and, likewise, the net assets of the consolidated group are reduced by a like amount.

It is therefore submitted that the Court of Appeals erred in denying the bond discount deductions and that this Court should grant certiorari on this question.

CONCLUSION.

Wherefore, it is submitted that the petition for certiorari should be granted.

Respectfully submitted,

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